State of California
Franchise Tax Board

03.04.09

G. Michelle Ferreira
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Dear Michelle Ferreira,

Thank you for your presentation at the Taxpayers' Bill of Rights Hearing held on 12.04.2008. I am responding to the issue you raised at the hearing.

Section 19774 Nest Penalty

In your letter, you stated that you have seen examples where this penalty was imposed when the taxpayer did not engage in a reportable transaction. By way of example, you indicated that the FTB has assessed the NEST penalty in a case involving a deferred private annuity for estate tax purposes after concluding that the transaction lacked economic substance and there was no valid California business purpose other than to generate tax losses. You have also seen the FTB assert a lack of economic substance in cases involving Internal Revenue Code (IRC) section 1031 exchanges, IRC section 704(b) partnership matters and other complicated transactions that you allege were organized for a variety of business purposes. In these situations, you claim that the Internal Revenue Service (IRS) traditionally does not find a lack of economic substance.

The NEST penalty applies to any transaction that lacks economic substance where no reasonable possibility of a profit exists or when an entity is disregarded because it lacks economic substance. It is also applicable when the taxpayer does not have a valid nontax California business purpose for entering into the transaction. This penalty is not limited to reportable and listed transactions.

Without knowing the specific facts of the case you reference in your letter, you should be aware that the NEST penalty may be appropriate when the transaction involves an offshore private annuity that has no business purpose other than to hide income offshore or attempt to defer income indefinitely. In fact, this type of scheme has been listed by the IRS as one of its Dirty Dozen for 2008. In addition, we have seen a number of abuses warranting imposition of the NEST penalty in estate and trust matters where substance over form, step transaction, or other judicial doctrines are appropriately applied.

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You also reference cases involving IRC section 1031 exchanges and IRC section 704(b), where the IRS generally does not assert a lack of economic substance. The FTB has asserted the penalty involving partnerships and the anti-abuse rules found in Treasury Regulation section 1.701-2. In those cases the FTB looks to see, for example, whether the taxpayer claimed a tax benefit in excess of the cash investment or whether there is an inflated basis due to creation of transitory and sham entities, use of circular cash and notes, and other steps that lack economic substance. The IRS does not always examine these types of transactions to determine if there is economic substance because it does not have a penalty similar to the NEST penalty.

Your comment that once imposed the taxpayer does not have any administrative or judicial recourse to contest the assessment of the penalty is not correct. First, the taxpayer may seek pre-payment review by filing a request for Chief Counsel Relief. The Chief Counsel may abate the penalty in whole or in part. The Chief Counsel's determination itself is not reviewable in any administrative or judicial proceeding (whatever reduction that the Chief Counsel grants is therefore permanent and cannot be reinstated). Section 19774 does not provide for any standards for review, and as you noted does not have a reasonable cause defense. However, there are other penalties with Chief Counsel review standards, and the Chief Counsel may consider those standards in making a determination to abate the NEST penalty in whole or in part. (See for example, Rev. & Tax. Code § 19772.)

Second, along with filing a request for penalty relief with the Chief Counsel, taxpayers may file a protest to contest substantively the FTBs conclusions regarding the economic substance and/or business purpose of the challenged transaction. If the protest hearing officer determines that there is economic substance or a valid nontax business purpose to the transaction, the Chief Counsel will abate the penalty in whole and that decision cannot be revisited in any judicial or administrative proceeding.

Third, taxpayers may also pay the penalty, file a claim for refund on substantive grounds, and if denied, file an appeal with the State Board of Equalization (Board) or file suit in Superior Court. Taxpayers may renew the argument either before the Board or the Superior Court that the challenged transaction has economic substance and/or a valid nontax business purpose.

Although it is true that the FTB has imposed the NEST penalty in cases where the IRS settled with the taxpayer for a reduced (or no) accuracy related penalty, California is not required to follow the federal determination and limit the penalty which it imposes to the accuracy related penalty, when California's legislature provided for a penalty that it considered necessary to combat these types of abusive transactions.

Legal and Audit are continuing to work together to ensure consistent and appropriate application of the NEST penalty, as intended by the California legislature.

Section 19777.5 Post-Amnesty Penalty

In 2004, the California Legislature authorized the FTB to institute an income tax amnesty program for taxable years prior to January 1, 2003. For eligible taxpayers who did not participate in amnesty, the FTB imposes a post-amnesty penalty under RTC section 19777.5 on amounts that become due and payable after the amnesty period that ended on March 31, 2005.

You are correct that the only way to challenge the post-amnesty penalty is for the taxpayer to pay the penalty and file a refund claim on the limited grounds that the amount paid to satisfy the penalty was not properly computed by the FTB. There were several proposals to provide some administrative relief for the post-amnesty penalty that California's legislature rejected in AB 1614 and AB 2326. Those included (1) allowing taxpayers to request Chief Counsel review in certain circumstances; (2) eliminating the post-amnesty penalty on balance due amounts that are the result of changes in the law following the conclusion of amnesty or the result of changes resulting from federal determinations; and (3) eliminating the post-amnesty penalty for taxpayer who made protective claim payments during amnesty that were in an amount equal to at least 90 percent of the final liability amount.

The Legislature rejected these proposals, but it did pass AB 911 (Stats. 2005, ch. 398), which provided for taxpayers to challenge the post-amnesty penalty on the limited grounds that the FTB computed the penalty incorrectly. The Legislature also eliminated the requirement that taxpayers remain in compliance for the 2005 and 2006 tax years to retain the benefit of amnesty.

The FTB is administering the post-amnesty penalty as provided by the State Legislature. As you are aware, because the penalty applies only to tax years prior to January 1, 2003, we should see fewer instances of this penalty for most taxpayers.

Section 19777 Interest-Based Penalty

This penalty applies to a taxpayer who has a deficiency and has been contacted by the FTB regarding the use of a potentially abusive tax avoidance transaction (for notices issued prior to January 1, 2005) or regarding the use of an undisclosed reportable transaction, a listed transaction or a gross misstatement (for notices issued on or after January 1, 2005, on any return where the statute of limitations for assessment has not expired).

You raised concerns with the meaning of the term "contact" for purposes of this penalty and suggested that even a posting on FTBs webpage could be considered contact. We do not interpret the term "contact" that broadly. On the contrary, our auditors are instructed that contact must be written correspondence sent to the taxpayer specifically asking about

potentially abusive tax avoidance transactions for the earlier years or undisclosed reportable transactions, listed transactions or gross misstatements for the later years.

Examples of written communication for purposes of this penalty include the Voluntary Compliance Initiative (VCI) mailer (defined as contact in RTC section 19751(e)), an initial audit contact letter, an information document request (IDR), a position letter or an audit issue presentation (AIP) sheet. Auditors have also been instructed that notification in an NPA alone is not sufficient contact to warrant imposition of the interest-based penalty.

Because there must be a deficiency, which is the amount by which the correct tax exceeds the amount shown on an original or amended return, taxpayers are able to avoid the penalty during the course of an audit by filing an amended return completely backing out the challenged transaction. Also, the interest-based penalty is imposed on an NPA, which may be protested. If during the protest the taxpayer establishes they did not participate in a potentially abusive tax avoidance transaction or an undisclosed reportable transaction, a listed transaction or a gross misstatement, the FTB will abate the penalty.

Audit and Legal are working closely to ensure that this penalty is imposed correctly in the appropriate cases, after fully developing the facts to support imposition of the penalty.

In conclusion, you assert that many taxpayers entered into these types of transactions based upon improper advice from unscrupulous tax practitioners and at a substantial cost to the taxpayer. Please note that the FTB looks at each case individually and only imposes the applicable penalty where appropriate.

Sincerely,

Steve Sims, EA
Taxpayers' Rights Advocate

cc: Hon. John Chiang, Chair
Hon. Betty T. Yee, Member
Hon. Michael C. Genest, Member